

IN THE UNITED STATES DISTRICT COURT  
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE: EQUIMED, INC.	:	MASTER FILE NO.
SECURITIES LITIGATION	:	98-cv-5374(NS)
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<hr/> This Document Relates to:	:	CLASS ACTION
ALL ACTIONS	:	
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MEMORANDUM and ORDER

Norma L. Shapiro, S.J.

May 9, 2000

Defendants move to dismiss this class action on behalf of shareholders of Equimed, Inc. ("Equimed"), a holding company for a group of companies providing physician practice management, information technology and outsourcing services to the health care industry. Plaintiffs have alleged a violation of Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act") by Equimed and several current and former officers and directors, including Daniel R. Colkitt, M.D. ("Colkitt"), Jerome Derdel, M.D. ("Derdel"), Raymond J. Caravan ("Caravan"), Daniel Beckett ("Beckett"), Larry W. Pearson ("Pearson"), Gene E. Burleson ("Burleson"), and Brian C. Smith ("Smith") (Count I), and a violation of section 20(a) of the Exchange Act by Colkitt (Count II). Defendants move to dismiss Count I of the amended complaint on three grounds: 1) failure to meet the strict standards for pleading securities fraud; 2) failure to state a claim upon which relief can be granted; and 3) failure to file within the statutory time period for securities litigation.

Defendant Colkitt moves to dismiss Count II on the grounds that it does meet the strict standard for pleading securities fraud. The motion to dismiss will be granted in part and denied in part.

### **FACTS**

Plaintiffs have alleged that Equimed made various misrepresentations and failed to disclose publicly material information concerning: 1) fraudulent double-billing of the Medicare and CHAMPUS federal health insurance programs; 2) deficiencies in Equimed accounting methods; 3) non-independence of some of Equimed's board members; and 4) involvement of two Equimed directors as defendants in a minority shareholder lawsuit. The class period alleged is from May 15, 1996, when Equimed filed a quarterly report ("10-Q") with the Securities and Exchange Commission ("SEC"), to June 22, 1998, when NASDAQ de-listed Equimed stock.

The first misrepresentation alleged by plaintiffs relates to a civil action filed by the United States against Equimed, Colkitt and others for double billing the Medicare and CHAMPUS programs between 1992 and 1997. (Pls.' Consolidated Am. Class Action Compl. ("Compl.") ¶¶ 40-65). The government's action is pending in United States District Court for the District of Maryland. Plaintiffs acknowledged during oral argument that the allegations in their complaint relating to double-billing are based on the government's complaint in that action.

Plaintiffs claim that as a result of double-billing, Equimed knowingly received millions of dollars to which it was not entitled; this deceived the public about its financial condition in the 1996 quarterly reports (Compl. ¶ 71), the 1996 10-K annual report (Compl. ¶¶ 80-81), a 1997 press release (Compl. ¶¶ 80-81), and the 1997 first, second and third quarterly reports for 1997 (Compl. ¶¶ 84, 90, 92).

Plaintiffs' next claim is that Equimed failed to disclose a May 21, 1997 letter stating that Ernst and Young, Equimed's independent auditor, was dissatisfied with Equimed's internal accounting procedures (Compl. ¶ 75). Plaintiffs also allege, more generally, that Equimed did not reveal existing deficiencies in its internal controls, (Compl. ¶ 80(d)), in the 1996 quarterly reports (Compl. ¶ 72), the 1996 10-K (Compl. ¶73), the 1997 press release (Compl. ¶¶ 76, 80), and the 1997 second and third quarterly reports (Compl. ¶¶ 90, 92).

Plaintiffs also claim a failure to disclose the lack of independence of Board members Derdel and Caravan. They allege that Derdel and Caravan were "long-time business partners" of Chairman Colkitt (Compl. ¶ 66) and that this was not disclosed in various filings, including the 1996 10-K (Compl. ¶¶ 80-81), the 1997 proxy statement (Compl. ¶ 85-86), the 1997 Form 8-K announcing Equimed's acquisition of ASI, one of Colkitt's companies (where Derdell was purported to be the independent

director who approved the transaction) (Compl. ¶ 87), and three 1997 quarterly reports (Compl. ¶¶ 84, 90, 92).

Finally, plaintiffs claim Equimed failed to disclose that Derdel and Caravan were defendants in litigation by minority shareholders of oncology centers merged first with Colkitt Oncology Group, and later with Equimed ("Minority Shareholder Litigation") (Compl. ¶ 73). The Equimed 1996 10-K and a 1997 press release purportedly disclose this litigation but do not reveal Derdel and Caravan were defendants (Compl. ¶ 80). Similar claims are made with regard to three 1997 quarterly reports (Compl. ¶¶ 82, 88, 90, 92).

Plaintiffs claim that all the above misrepresentations resulted in artificial inflation in the price of Equimed stock during the class period (Compl. ¶ 107). Count I alleges that these misrepresentations constitute a violation of § 10(b) of the Exchange Act.

Section 20(a) of the Exchange Act imposes liability for underlying violations of § 10(b) on "control persons." Count II alleges that Colkitt violated § 20(a) because his high-level position with the company and extensive day-to-day involvement in its operations gave him control over the misstatements and omissions alleged in Count I (Compl. ¶¶ 110-113).

#### **DISCUSSION**

## **I. Sufficiency of the Pleadings under the Reform Act.**

The Private Securities Litigation Reform Act of 1995 ("Reform Act") imposes a heightened pleading standard in securities fraud actions. The Reform Act requires a specification of each misleading statement, the reasons why the statement is misleading, and the facts on which the belief is formed if the allegation is made on information or belief. 15 U.S.C.A. § 78u-4(b)(1) (West 1997). The Reform Act also requires the plaintiff, for each alleged act or omission, to allege "with particularity" facts that give rise to a strong inference that the defendant acted with the required state of mind. 15 U.S.C.A. § 78u-4(b)(2) (West 1997).<sup>1</sup>

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<sup>1</sup> The Reform Act states:

(1) Misleading statements and omissions

In any private action arising under this chapter in which the plaintiff alleges that the defendant -

(A) made an untrue statement of material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind

To satisfy the scienter pleading requirement in subsection (2), the Reform Act requires a plaintiff to allege "facts establishing a motive and an opportunity to commit fraud," or to set forth "facts that constitute circumstantial evidence of either reckless or conscious behavior." In re Advanta Corp. Securities Litigation, 180 F.3d 525, 534 (3d Cir. 1999). The facts must be stated with particularity and give rise to a "strong inference" of the scienter required. Id.

A. 15 U.S.C. § 78u-4(b)(1)

1. Misleading Statements and Omissions

Plaintiffs' allegations about Medicare and CHAMPUS fraud satisfy the specificity requirements of the Reform Act. Paragraphs 40 - 64 of the complaint include detailed allegations of this fraud, and the complaint describes how Equimed's earnings were misstated in numerous filings and other statements issued by the company since they were partially based on the false Medicare and CHAMPUS claims.

With respect to the allegation of deficient accounting procedures, the complaint states with specificity what is alleged

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In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C.A. § 78u-4(b) (West 1997).

to be misleading and why. Plaintiffs cite the Ernst and Young letter identifying deficiencies in Equimed's internal controls, (Compl. ¶ 75), and filings omitting any information about this letter, or inadequate controls (Compl. ¶¶ 72, 73, 76, 80, 92). Plaintiffs also allege that non-disclosure of these deficiencies was misleading because investors were not on notice of the true reasons for Equimed's losses or its delay in filing its 1996 10-K; the public was led to believe that they were caused by other, less disturbing reasons. (Compl. ¶ 76).

The allegations of failure to disclose the non-independence of certain directors are also adequate under 4(b)(1) of the Reform Act. According to the complaint, the 1996 10-K announced the resignations of all directors except Colkitt and Derdel, and stated that under the terms of a merger agreement, Colkitt must vote all his shares to elect at least three independent Board members. (Compl. ¶ 78). The 1996 10-K contained a short biography of Derdel, but did not reveal that Derdel worked for other corporations owned by Colkitt, i.e., it did not reveal his lack of independence (Compl. ¶¶ 79). The 1997 8-K in announcing the acquisition of ASI stated the transaction was approved by Equimed's "independent director," supposedly Derdel. (Compl. ¶ 87.) The 1997 proxy statement is also alleged to have described the backgrounds of Caravan and Derdel without revealing their lack of independence. (Compl. ¶ 85.) Plaintiffs contend that the

failure to disclose the absence of any independent director, when it was stated that a transaction was approved by the "independent director," was misleading. (Compl. ¶¶ 65, 66, 78.)

Because the allegations of misleading statements and omissions about the minority shareholder litigation against Equimed are related to the lack of director independence, the complaint tends at times to merge these two issues. These allegations do not satisfy the materiality standard of 12(b)(6), see infra, so we need not address whether they satisfy the Reform Act pleading requirements.

## 2. Information and Belief

If allegations are made on information and belief, plaintiff must state with particularity all facts on which that belief is founded. 15 U.S.C. § 78u-4(b)(1). Plaintiffs contend that because their allegations are based upon "investigation of counsel" rather than "information and belief," that provision of the Reform Act's pleading requirements does not apply.

There is no binding authority on whether plaintiffs must state with particularity all facts on which their belief is formed when the allegations are based on "investigation of counsel." See Warman v. Overland Data, 1998 WL 110018 at \*3 (S.D. Cal. Feb. 20, 1998) ("[A]s plaintiffs have pled their allegations based on investigation of the attorney and not upon information and belief, the complaint need not state with

particularity all the facts on which the belief is formed."); In re Aetna Inc. Securities Litigation, MDL No. 1219, Order No. 8, n.1 (E.D. Pa. March 24, 1999). But see In re Green Tree Financial Corp. Stop Litigation, 61 F. Supp. 2d 860, 872 (D. Minn. 1999) ("[B]ecause an attorney is required, under Rule 11 of the Federal Rules of Civil Procedure, to investigate claims before filing a complaint, plaintiffs should not be allowed to avoid the heightened pleading standard by claiming "investigation of counsel."); In re 3Com Securities Litigation, 1999 WL 1039715, \*4 (N.D. Cal. 1999). To distinguish between "information and belief" and "investigation of counsel" is meaningless; it would permit evasion of the clear intent of a statutory mandate. Plaintiffs must state with particularity those facts upon which their allegations are formed, even if made upon "investigation of counsel."

However, plaintiffs have adequately stated those facts for all their allegations. Detailed facts about Medicare and CHAMPUS fraud are cited from the action of the United States against Equimed. (Compl. ¶¶ 1, 40 - 64.) The 1997 Ernst & Young letter is specifically cited (Compl. ¶ 75) to support the misrepresentations of Equimed's accounting deficiencies. Plaintiffs cite testimony in the minority shareholder litigation to support their allegations that Derdel and Caravan were involved in that litigation and were not independent directors.

(Compl. ¶¶ 16, 17, 73.) The SEC filings omitting those matters are cited with specificity. The pleadings comply with 15 U.S.C. § 78u-4(b)(1).

B. 15 U.S.C. § 78u-4(b)(2) - Scienter

To recover damages for securities fraud, plaintiffs must prove that defendants(s) acted with a particular state of mind; the complaint must either allege with particularity facts "establishing a motive and an opportunity to commit fraud," or set forth "facts that constitute circumstantial evidence of either reckless or conscious behavior." In re: Advanta Corp. Securities Litigation, 180 F.3d at 534 - 535. Plaintiffs must support their scienter allegations with facts stated "with particularity" that give rise to a "strong inference" of scienter. See Advanta, 180 F.3d at 535.

The Advanta court, affirming the dismissal of a securities fraud complaint, found, inter alia, that the dismissed complaint failed to comply with the Reform Act's scienter requirement. Advanta, a credit card issuer, issued cards with low "teaser" rates for long introductory time periods; they attracted risky customers and resulted in increased delinquency rates decreasing Advanta's revenues substantially. See Advanta, 180 F.3d at 528. Plaintiffs alleged that Advanta failed to disclose this practice, and made misleading statements about its intention to convert the "teaser" rates to higher rates and increase revenues. See id.

Plaintiffs also alleged misleading statements about the company's status. See id. at 528 - 29. The court held the complaint pled no specific facts to support an inference that defendants had specific knowledge of the falsity of the company's intention to convert the interest rates, or the inaccuracy of other statements. See id. at 536, 539. An allegation that a defendant "must have known" a statement was false or misleading was insufficient. Id. at 539 (citations omitted).

Plaintiffs here allege that the defendants acted knowingly or with reckless disregard because: 1) defendants had possession of information regarding the true nature of the business; 2) defendants had control over the misleading misstatements; 3) defendants were involved in the day-to-day business of the company; 4) defendants were in positions that made them privy to confidential information; 5) the material evidence existed during the class period; and 6) some of the defendants were parties to the partially concealed minority shareholder litigation. (Compl. ¶¶ 97 - 98.) Plaintiffs allege that the defendants were motivated by a desire to enhance the value of their personal Equimed holdings or other benefits they received from their employment with Equimed. (Compl. ¶ 99.)

Plaintiff's complaint does not sufficiently allege facts giving rise to a "strong inference" of motive and opportunity to commit any of the alleged fraudulent acts. Although it includes

conclusory allegations about the motivations of "the individual defendants" based on their personal holdings of Equimed stock, their salaries and other benefits as Equimed employees, (Compl. ¶ 99), no specific facts are alleged concerning which individuals defendants own stock, and how much they own, apart from defendant Colkitt. None of the individual defendants are alleged to have sold stock to profit from misrepresentations. Even if this were alleged, fraudulent intent cannot be inferred from the mere fact that some officers sold stock. See Advanta, 180 F.3d at 540.

Plaintiffs have not included circumstantial evidence of either reckless or conscious behavior with respect to the Medicare and CHAMPUS fraud claims. Plaintiffs rest this claim on the existence of a lawsuit filed by the United States against Equimed. The complaint alleges Colkitt knew about the misconduct that is the subject of that lawsuit, but no stated facts support this allegation other than Colkitt's position in the company. As held in Advanta, that is insufficient to satisfy the scienter pleading requirement.

However, plaintiffs have included facts that constitute circumstantial evidence of either reckless or conscious behavior by defendants Colkitt, Derdel, Beckett, Pearson, Burleson and Smith regarding the accounting deficiencies, and by defendants Colkitt, Derdel and Caravan regarding the director non-independence. Plaintiffs do not allege defendants must have

known the statement were false or misleading because of the defendants' positions in the company; they cite the Ernst & Young letter, allegedly sent to every director at the time, which included every defendant but Caravan. (Compl. ¶ 77.) Derdel and Carvan obviously knew of their own non-independence, and a strong inference can be made that Colkitt knew of it since they are alleged to have worked for him. However, the complaint does not state with particularity any other facts that create a strong inference that the other individual defendants knew of Derdel and Carvan's non-independence.

Plaintiffs have therefore supported their scienter allegations only on their claims involving deficient accounting procedures and director non-independence. The former allegations are supported with respect to every individual defendant but Caravan; the latter are supported only with respect to defendants Colkitt, Derdel and Caravan.

## **II. Sufficiency of the Pleadings under Fed. R. Civ. P. 9(b)**

Federal Rule of Civil Procedure 9(b) requires that a plaintiff alleging fraud must state the circumstances constituting fraud with particularity. Because this requirement is no stricter than that established by the Reform Act, we need not analyze plaintiffs' claims separately under Rule 9(b). Those allegations of fraud that comply with the Reform Act pleading standard also satisfy this Rule. See, e.g., Advanta, 180 F.3d

525 n.11.

### **III. Failure to State a Claim under 12(b)(6)**

A plaintiff stating a securities fraud claim under Section 10(b) and Rule 10b(5) must plead: "1) that the defendant made a misrepresentation or omission of 2) a material 3) fact; 4) that the defendant acted with knowledge or recklessness; and 5) that the plaintiff reasonably relied on the misrepresentation or omission and 6) consequently suffered damage." In re Westinghouse Securities Litigation, 90 F.3d 696, 710 (3d Cir. 1996). Defendants argue that plaintiffs' allegations of materiality and causation are deficient. Liability standards are not affected by the Reform Act; the court must evaluate them under usual Rule 12(b)(6) standards. The court "must take all the well pleaded allegations as true, construe the complaint in the light most favorable to the plaintiff, and determine whether, under any reasonable reading of the pleadings, the plaintiff may be entitled to relief." Colburn v. Upper Darby Township, 838 F.2d 663, 665 (3d Cir. 1988), cert. denied, 489 U.S. 1065 (1989); see Rocks v. City of Philadelphia, 868 F.2d 644, 645 (3d Cir. 1989). The court must decide whether "relief could be granted on any set of facts which could be proved." Ransom v. Marrazzo, 848 F.2d 398, 401 (3d Cir. 1988). A motion to dismiss may be granted only if the court finds the plaintiffs can prove no set of facts in support of their claim which would entitle them to relief.

See Conley v. Gibson, 355 U.S. 41, 45 (1957).

A. Materiality

Information is "material" if there is a substantial likelihood that, under all the circumstances, the information would have assumed "actual significance in the deliberations of the reasonable shareholder." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); Basic v. Levinson, 485 U.S. 224, 231 - 232 (1988) (expressly adopting the materiality standard of TSC Industries for use in § 10(b) and Rule 10b-5 cases). There must be a "'substantial likelihood' that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'" Basic, 485 U.S. at 231 - 232 (quoting TSC Industries, 426 U.S. at 449). Materiality has been characterized as a mixed question of law and fact, because the trier of fact makes an assessment of "reasonableness." See TSC Industries, 426 U.S. at 450. Defendants argue that the facts plaintiffs contend were withheld from the public were either fully disclosed or immaterial.

Although the Medicare and CHAMPUS fraud allegations do not satisfy the scienter requirement, the alleged fraud would be material to a shareholder's decision to purchase Equimed securities; a shareholder with knowledge of this fraud might expect that the company would at some point be required not only

to return the overcharges but also pay substantial penalties.

The adequacy of internal controls would be material to a shareholder's decision to buy and sell. Such an allegation survives a motion to dismiss as long as plaintiffs plead adequate facts supporting the allegation. Cf. In re Westinghouse Securities Litigation, 90 F.3d 696, 711 - 712 (3d Cir. 1996).

Mismanagement alone would not be sufficient to state a claim under § 10(b), even though it might constitute a breach of fiduciary duty. See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476 (1977). There must be some element of deception, misrepresentation, or non-disclosure pertaining to the mismanagement to state a claim for fraud. See id.

Plaintiffs base this allegation on a specific piece of undisclosed information: the Ernst & Young letter. Equimed is alleged not simply to have failed to disclose its own negligence (which might not be actionable under § 10(b)), but the discovery of this negligence by its auditor. There is a substantial likelihood that the facts in this letter, if true, would significantly affect the decision of a reasonable shareholder. We cannot say that this alleged omission is "so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality." See Shapiro v. UJB Financial Corp., 964 F.2d 272, 280 n.11 (3d Cir. 1992) (citing TSC Indus., 426 U.S. at 450). Plaintiff's claim for fraudulent failure to

disclose deficient accounting procedures claim survives to the extent it alleges the failure to disclose the Ernst and Young letter as its basis.

The allegation that Equimed failed to disclose that Derdel and Caravan were not independent directors raises factual issues precluding a motion to dismiss on materiality grounds.

Plaintiffs allege the 1996 10-K announced the resignation of all Equimed directors except Colkitt and Derdel, but also stated that there must be at least three independent members of the Board as long as Colkitt owned in excess of 20% of Equimed stock. (Compl. ¶ 78.) This same filing including a brief biography of Derdel but failed to disclose any lack of independence. (Compl. ¶ 79.) After reading the 1996 10-K in its entirety, investors could logically assume Derdel was independent. Because independent directors must approve interested director transactions, a reasonable shareholder's decision to invest arguably would have taken into account the independence, or lack thereof, of company directors, especially after learning most of the board had resigned.

Plaintiffs' complaint acknowledges Equimed disclosed the minority shareholder litigation but asserts that it did not reveal that Derdel and Caravan were defendants. (Compl. ¶ 80(c).) It is unclear from the complaint why, given the disclosure that Equimed and Colkitt were defendants, the failure

to disclose that directors Derdel and Carvan were defendants was material. This omission is insufficient to state a claim under Rule 10b-5.

B. Causation

A plaintiff asserting a Rule 10b-5 claim must prove some causal connection between the alleged fraud and the harm incurred by the purchase or sale of the securities. See Angelastro v. Prudential-Bache Securities, Inc., 764 F.2d 939, 944 (3d Cir. 1985). According to the complaint, in April and June, 1998, Equimed made various announcements concerning an extension of the deadline for filing its 1997 10-K, its NASDAQ de-listing for failure to issue annual audited financial statements, and losses of ASI (an Equimed subsidiary acquired from Colkitt in July 1997). Equimed disclosed its intention to restate 1997 quarterly reports in July, 1998. (Compl. ¶¶ 93 - 95.) The share price is alleged to have dropped \$4 as a result of the April 3rd disclosures, (Compl. ¶¶ 3, 93), which were "vague references to the resulting negative financial impact on Equimed of Defendant Colkitt's unchecked manipulation of Equimed's assets, revenues, and stock price." (Compl. ¶ 3.) The NASDAQ delisting for failure to file financial statements and ASI bankruptcy are also alleged to have resulted in a drop in share price to \$5.375 on June 22, 1998 (Compl. ¶ 4.)

In addition to failing to satisfy the Reform Act pleading

standard, the Medicare/CHAMPUS fraud allegations insufficiently plead causation. The purported class period ends in June, 1998, but the government's Medicare/CHAMPUS fraud action was not made public until late August, 1998. Plaintiffs assert that the fraud caused an inflation in Equimed's earnings; they do not allege that filing that action or public disclosure of the fraud caused the price to drop within the class period.

Causation is sufficiently alleged for plaintiffs' claims based on the misleading statements or omissions relating to Equimed's accounting practices and the non-independence of Equimed's directors to survive a motion to dismiss. They allege a drop in price either because of inadequate financial statements (presumably caused by the subject of the undisclosed letter, inadequate internal controls) or losses because ASI was acquired in an interested director transaction.

We need not address the causation argument for the minority shareholder litigation allegations since those allegations are dismissed on other grounds.

#### **IV. Statute of Limitations**

Defendants argue that all of plaintiffs' claims arising from statements made prior to October 9, 1997 must be dismissed as time barred under the one year limitations period for claims under §10(b) of the Exchange Act, 15 U.S.C. §78j(b). The statute of limitations for § 10(b) and Rule 10b-5 is one year after

discovery but no more than three years after the actual violation. See Lorenz v. CSX Corp., 1 F.3d 1406, 1418 (3d Cir. 1993). A statute of limitations defense is inappropriately asserted by a motion to dismiss unless the complaint shows facial noncompliance with the limitations period and the affirmative defense clearly appears on the face of the pleading. See Oshiver v. Levin, Fishbein, Sedran & Berman, 38 F.3d 1380, 1384 n.1 (3d Cir. 1994) (citing Trevino v. Union Pacific Railroad Co., 916 F.2d 1230 (7th Cir. 1990)).

The one-year period begins when plaintiffs had "sufficient information of possible wrongdoing to place them on 'inquiry notice' or to excite 'storm warnings' of culpable activity." Leach v. Quality Health Services, Inc., 902 F. Supp. 554, 557 (E.D. Pa. 1995). This happens when "a person of ordinary intelligence would have suspected that he or she was being defrauded." Id.

On a motion to dismiss, defendants bear a heavier burden in showing that such inquiry notice existed more than one year before plaintiffs filed the complaint. The first complaint in this action was filed on October 9, 1998. Defendants claim that plaintiffs had notice of sufficient possibility of fraud to give rise to a duty of inquiry by June 10, 1997, the date Equimed filed its 1996 Form 10-K. Defendants argue that the 1996 10-K gave plaintiffs notice of their claims because: 1) it was filed

over two months late; 2) most of Equimed's directors suddenly resigned soon after its filing; 3) the 10-K revealed that Equimed

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had been required to restate its earnings for 1996; 4) the newly revealed loss was more than twice the amount previously disclosed; and 5) more information about the minority shareholder litigation was disclosed. (Def.'s Mem. in Supp. of their Mot. to Dismiss the Consolidated Amended Class Action Compl. at 10-11.)

Had the Medicare and CHAMPUS fraud claim otherwise survived the motion to dismiss, it would not be barred by the statute of limitations. The Department of Justice lawsuit against Equimed arising from this alleged fraud was not filed until 1998 (Compl. ¶ 1). Nothing in the complaint suggests plaintiffs had knowledge of the alleged fraud, or had reason to investigate it, before that lawsuit was filed.

With respect to their allegations of deficient accounting procedures and failure to disclose the Ernst & Young letter, plaintiffs allege they had no knowledge of the letter until August 21, 1998, when Ernst & Young disclosed it. (Compl. ¶ 75.) The 1996 10-K revealed that Equimed was experiencing financial troubles, but did not disclose or suggest the existence of the Ernst & Young letter.

Nor does the face of the complaint reveal a duty of inquiry as to the third and fourth bases for plaintiffs' claims.

Plaintiffs allege that Equimed continued to fail to disclose the non-independence of Derdel and the involvement of other directors in the minority shareholder litigation as late as the third quarter 10-Q filing on November 14, 1997. In fact, part of plaintiff's complaint alleges the 1996 10-K filing was itself misleading with respect to these matters.

It is not clear from the face of the complaint that plaintiffs had warnings giving rise to a duty of inquiry as to any of the matters upon which they base their claims following Equimed's filing its 1996 10-K. There is at least a factual issue whether the late filing or the subsequent resignation of most directors was sufficient to put plaintiffs on notice of Rule 10b-5 violations, rather than just poor financial performance. Defendants point to several "why" questions that "any reasonable investor" would have asked about the 1996 10-K, (Def.'s Mem. in Supp. of their Mot. to Dismiss the Consolidated Amended Class Action Compl. at 13), but a motion to dismiss is inappropriate for resolving these reasonableness issues. See, e.g., Nevada Power Co. v. Monsanto Co., 955 F.2d 1304, 1307-08 (9th Cir. 1992) (whether a plaintiff exercised reasonable diligence in discovering the cause of action is a question of fact). Defendants' motion to dismiss based on the § 10(b)(5) statute of limitations will be denied.

#### **V. Plaintiff's Claim under § 20(a) of the Exchange Act**

Section 20(a) of the Exchange Act imposes joint and several

liability on any person who "controls a person liable under any provision of" the Exchange Act. 15 U.S.C.A. § 78(t)(a) (West 1997). Whether a defendant is a "controlling person" is a question of fact which cannot ordinarily be resolved at the pleading stage. See In re Chambers Development Sec. Litigation, 848 F. Supp. 602, 618 (W.D. Pa. 1997); In re World of Wonders Sec. Litig., 694 F.Supp. 1427, 1435 (N.D. Cal.1988).

To maintain a claim under Section 20(a), the plaintiff must establish: (1) an underlying violation by a controlled person or entity; (2) that the defendants are controlling persons; and (3) that they were "in some meaningful sense culpable participants in the fraud." In re Cendant Corporation Securities Litigation, 2000 WL 116226, \*7 (D.N.J.). The heightened standards of the Reform Act apply to a § 20(a) claim, so "a plaintiff must plead particularized facts of the controlling person's conscious misbehavior as a culpable participant in the fraud." In re Cendant Corporation Securities Litigation, 76 F. Supp. 2d 539, 549 n.5 (D.N.J. 1999) (dismissing § 20(a) claim for failure to state an underlying § 10(b) claim).

Plaintiffs allege a § 20(a) violation only against defendant Colkitt. These allegations are sufficient to support an inference of control. Plaintiffs allege that Colkitt, by virtue of his majority stock ownership, high-level position in the company, unlimited access to company information, and direct

involvement in the day-to-day operations of the company, had the power to control or influence the transactions giving rise to the Rule 10b-5 violations. (Compl. ¶¶ 111-112.) The allegations of scienter that satisfy the Reform Act standard with respect to the underlying Rule 10b-5 violation would also satisfy a heightened pleading standard for the § 20(a) claim. Because plaintiffs have only stated a sufficient § 20(a) claim against Colkitt to the extent that the underlying § 10(b) claim is valid,<sup>2</sup> see Advanta, 180 F.3d 525, 541 ("[C]laims under section 20(A) are derivative, requiring proof of a separate underlying violation of the Exchange Act."), plaintiffs' § 20(a) claim fails with respect to those allegations which we are dismissing for inadequately pleading a Rule 10b-5 violation: the Medicare and CHAMPUS fraud and the non-disclosure of the details of the minority shareholder litigation.

### **CONCLUSION**

Plaintiffs' claims under sections 10(b) and 20(a) of the Exchange Act are inadequate in pleading misrepresentations or omissions concerning alleged Medicare and CHAMPUS fraud and the

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<sup>2</sup> Defendants even appear to concede that a §20(a) claim is adequately plead with respect to Colkitt if the underlying §10(b) claim is adequate. They argue that "[p]laintiffs have failed to plead specific facts that could support a finding that any of the Individual Defendants (except for Dr. Colkitt) possessed "control" over Equimed or that they were in anyway culpable participants in any wrongdoing." (Def.'s Mem. in Supp. of their Mot. to Dismiss the Consolidated Amended Class Action Compl. at 45 (emphasis added).)

minority shareholder litigation. The claims will be dismissed insofar as they relate to those allegations. Plaintiffs' claim based on the non-disclosure of inadequate accounting methods is inadequately pled against defendant Caravan, and plaintiffs' claim based on a lack of director independence is inadequately pled against defendants Beckett, Pearson, Burleson and Smith. Those claims will be dismissed as to those defendants. Defendants' motion to dismiss will otherwise be denied.

An appropriate Order follows.

THE UNITED STATES DISTRICT COURT  
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE: EQUIMED, INC.	:	MASTER FILE NO.
SECURITIES LITIGATION	:	98-cv-5374(NS)
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<hr/> This Document Relates to:	:	CLASS ACTION
ALL ACTIONS	:	
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PRETRIAL ORDER NO. 11

AND NOW, this 9th day of May, 2000, upon consideration of defendants' motion to dismiss the Consolidated Amended Class Action Complaint, and all responses and supplemental memoranda

thereto, it is **ORDERED** that:

1. It appearing that defendant Equimed, Inc. has filed a suggestion of bankruptcy, plaintiffs' claims against Equimed, Inc. are **SEVERED** and **STAYED** pending disposition of the bankruptcy. Counsel for Equimed, Inc. shall advise the court in writing of the status of this matter on or before **August 2, 2000.**

2. As to all defendants other than Equimed, Inc.:

A. Defendants' motion to dismiss the Consolidated Amended Class Action Complaint is **GRANTED IN PART** and **DENIED IN PART.**

(i). With respect to plaintiffs' claims of misstatements or omissions based on alleged Medicare and CHAMPUS fraud and the minority shareholder litigation, defendants' motion is **GRANTED** on both counts.

(ii). With respect to plaintiff's claim concerning non-disclosure of inadequate accounting methods, defendants' motion to dismiss is **GRANTED** as to defendant Raymond J. Caravan, and **DENIED** as to defendants Daniel R. Colkitt, Jerome Derdel, Daniel Beckett, Larry W. Pearson, Gene E. Burleson, and Brian C. Smith.

(iii). With respect to plaintiff's claim concerning the lack of independence of certain directors, defendants' motion to dismiss is **GRANTED** as to defendants Daniel Beckett, Larry W. Pearson, Gene E. Burleson, and Brian C. Smith, and **DENIED** as to defendants Daniel R. Colkitt, Jerome Derdel, and Raymond J. Caravan.

3. Plaintiff shall file a Revised Consolidated Amended Class Action Complaint in accordance with this order on or before **May 30, 2000.**

4. All defendants other than Equimed, Inc. shall file an answer to plaintiff's Revised Consolidated Amended Class Action Complaint on or before **June 19, 2000.**

5. A status and discovery conference will be held on **June 22, 2000** at **9:30 AM.** Counsel shall meet and confer on an agenda and discovery schedule one week prior thereto; failing agreement,

plaintiff and defendants may each make submissions regarding the matters to be considered at the conference no later than the day before the conference.

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S.J.